Modification Report
Introduction of a Negative Firm Overrun Charge
Modification Reference Number 0554
Version 1.0

This Modification Report is made pursuant to Rule 8.9 of the Modification Rules and follows the format required under Rule 8.9.3.

1. The Modification Proposal

It is proposed to introduce a new overrun charge to be applied to Users that end the day with a firm capacity holding less than zero. The new charge would be in addition to the standard overrun charge levied if a User's gas allocation exceeds its net capacity holding and would apply on a "greater of" basis with the existing negative overrun charge. The price used would be the same price as that used for the existing overrun charges and any revenues would be treated in the same way as other revenues from overrun charges.

The Proposal would be implemented with effect from 1st October 2002.

2. Transco's Opinion

Transco supports implementation of this Proposal. It is aware that a number of Users trade more firm entry capacity than they hold, using interruptible entry capacity to ensure that they maintain a positive end of day entry capacity holding. This activity effectively increases the total quantity of firm capacity beyond that released by Transco, because the accrued rights for interruptible capacity cannot be scaled (e.g. at 18:00 within day, a User's end of day interruptible capacity holding cannot be reduced by more than 50%, even if a 100% scaling factor is applied). Therefore opportunities are created for Users to effectively trade interruptible capacity as a firm product.

These actions potentially result in an increase in the effective level of firm capacity available to the market above that which Transco released, and therefore potentially an increased buy-back requirement. This may lead to increased costs for both Users (via capacity neutrality) and Transco (via its buy-back incentive).

3. Extent to which the proposed modification would better facilitate the relevant objectives

This Proposal would increase the efficient and economic operation of the entry capacity regime because it discourages the creation of firm capacity beyond that released in Transco's primary allocation and therefore furthers the relevant objective Standard Condition 7(1)(a) of Transco's GT Licence.

4. The implications for Transco of implementing the Modification Proposal , including

a) implications for the operation of the System:

The Proposal would enable Transco to manage entry capacity in a more efficient and economic manner. It would incentivise Users not to effectively create additional firm capacity beyond that which Transco has released in a primary allocation. The quantity of firm capacity is therefore more likely to be consistent with the quantity released in primary allocations.

b) development and capital cost and operating cost implications:

No significant costs are anticipated.

c) extent to which it is appropriate for Transco to recover the costs, and proposal for the most appropriate way for Transco to recover the costs:

Any additional System Operator costs incurred as a result of implementing this Proposal would be accounted for under the proposed internal cost incentive scheme, as set out in Ofgem's final proposals for System Operator incentives.

d) analysis of the consequences (if any) this proposal would have on price regulation:

There are no such consequences.

5. The consequence of implementing the Modification Proposal on the level of contractual risk to Transco under the Network Code as modified by the Modification Proposal

If more firm capacity is in circulation than that released by Transco then there is a clear risk of increased capacity management costs. All such costs represent a shared liability between Users and Transco.

6. The development implications and other implications for computer systems of Transco and related computer systems of Users

Systems developments will be required to implement this Proposal, and it is anticipated that these could be delivered at the beginning of December, to be included in the October overrun invoice.

7. The implications of implementing the Modification Proposal for Users

Users that trade more firm entry capacity than they hold and retain a firm capacity holding less than zero at the end of the gas flow day, would be charged an overrun charge based on the extent to which their holding is negative. All overrun charges will contribute towards Transco's buy back incentive and consequently will be included in capacity neutrality.

8. The implications of implementing the Modification Proposal for Terminal Operators,Consumers, Connected System Operators, Suppliers, producers and, any Non-Network Code Party

There are no such implications.

9. Consequences on the legislative and regulatory obligations and contractual relationships of Transco and each User and Non-Network Code Party of implementing the Modification Proposal

There are no such consequences.

10. Analysis of any advantages or disadvantages of implementation of the Modification Proposal

Advantages:
- reduction in buy back costs for Transco and Users

Disadvantages:
- increased complexity in the entry capacity regime

11. Summary of the Representations (to the extent that the import of those representations are not reflected elsewhere in the Modification Report)

Ten representations were received:

Agip (UK) Ltd (Agip)
British Gas Trading Ltd. (BGT)
Statoil (UK) Ltd (Statoil)
Shell Gas Direct (SGD)
TXU Europe Energy Trading Limited (TXU)
Powergen UK Plc. (Powergen)
SSE Energy Supply Ltd. (SSE)
London Electricity Group Plc. (LE)
Dynegy UK Ltd. (Dynegy)
El Paso Marchant Energy Group (EPMEG)

Five respondents (Statoil, SGD, SSE, LE, TXU) support the Proposal.
One respondent (Dynegy) did not express a definitive position in respect of this Modification Proposal.
Four respondents (BGT, Powergen, EPMEG, Agip) do not support the Proposal.

<u>11.1 Buy Back Costs</u>

Four respondents (Statoil, SGD, SSE and LE) considered that the implementation of this Modification Proposal would reduce buy back costs. SGD commented "the creation of 'virtual' firm capacity means that the total amount of capacity that Transco needs to buy back to resolve a constraint may be higher than if no 'virtual' capacity existed. The cost of buying back this extra capacity will feed into capacity neutrality, adding to costs."

However El Paso does not believe that the transfer of interruptible capacity as firm should have any effect on buy back costs because, “the capacity is either being used for physical flow or not, so the level of buybacks should not change dependant on who is the registered owner of that capacity at any point in time”. Powergen considers the Proposal provides “another mechanism for Transco to ‘sterilise’ within-day capacity without recourse to buy-back actions, thereby enabling it to make more money under its incentive”.

Transco Response

Transco agrees with Statoil, SGD, SSE and LE that this Proposal should reduce buy back costs for both Transco and Users.

Transco does not agree with the El Paso argument that the transfer of interruptible capacity as firm will not have an effect on buy back costs. If interruptible capacity is not used in the early part of a gas day then accrued rights could safely be sold on as firm capacity in the later part of the same Gas Day. In the event of flows turning up mid way through a day which necessitates capacity management activity on the part of Transco, then a greater quantity of firm capacity buy-back might be required because interruption is not a practical solution for managing accrued capacity rights.

Transco considers that the proposed capacity buy back incentive is set on the basis of the baseline quantities of firm capacity that it is required to offer to Users. If the stock of firm entry capacity can be further increased beyond that released by Transco then potentially capacity management costs will be increased for both Users and Transco.

11.2 Impact on Capacity Market

Four respondents (Statoil, SGD, Agip, EPMEG) commented on the effect of this Modification Proposal on the development of a secondary market for entry capacity.

Statoil observed “the removal of interruptible capacity being utilised as firm capacity should promote competition in the firm capacity market”. SGD believes that the Proposal should “ensure more robust price signals and contribute to effective competition between shippers”.

EPMAG and Agip expressed concern that the Proposal could adversely affect the secondary market for capacity; Agip commented that it “does not want to see measures introduced that will adversely affect the liquidity of any secondary market for entry capacity”.

SSE believes that the Proposal “is likely to inflate demand for firm capacity”.

Transco Response

Transco agrees with Statoil and SGD that this Proposal, if implemented, should promote competition for firm capacity. It does not anticipate that this Proposal would have any significant impact on the operation of the secondary market as it will still be possible for Users to take a negative position for firm capacity within day and to trade interruptible capacity.

11.3 Treatment of Interruptible Capacity

Three Users (BGT, EPMEG, Powergen) commented on the treatment of interruptible versus firm capacity. BGT commented, "the Interruptible capacity that has been used prior to curtailment has, to all intents and purposes, become a firm holding". EPMEG observed "interruptible capacity does not differ from firm capacity until an interruption notice has been issued and it can be treated as firm and used as firm up until that point" and that if the 1/24 flow rate principle is applied "then anything prior to the interruption notice is classed as firm". Powergen considers that the "proposal retrospectively alters the relative value shippers place on firm and interruptible capacity" and states "currently interruptible capacity effectively becomes firm at n/24 times the interruptible holding at the time of interruption".

Transco Response

Transco agrees with respondent views that accrued interruptible capacity that has been used effectively becomes firm, however interruptible capacity that has not been used should be deemed to have been consumed, such that n/24 times the interruptible holding at the time of interruption has been used. The issue that this Proposal addresses is that of unused interruptible capacity that has accrued to a User, which that User then carries forward and trades to another User for use as *firm* capacity later in the day

11.4 Availability Of Interruptible Capacity

Agip, LE, Powergen and BGT suggested that the amount of interruptible capacity offered for sale should be reduced. Powergen observed "if Transco is uncertain as to whether it can meet its interruptible contractual obligations it should simply interrupt earlier, to reduce the overall supply of interruptible capacity that has or may become 'firm'. BGT expressed the opinion that "Transco must take the possibility 'overselling of firm capacity' into account when offering interruptible capacity to Users" and "availability of firm capacity and the likelihood of interruption in the circumstances which prevail".

Dynegy suggested an alternative solution "would be to reduce the capacity entitlement when trading interruptible entry capacity throughout the day. The RGTA system would prevent users from selling interruptible capacity as firm through the users' entitlement to trade interruptible capacity being reduced upon the passing of each hour". It observes, "unlike the original proposal, that shall require the additional financing of invoices and system to implement the overrun charge, the alternative suggestion requires minor adjustments to the RGTA system".

LE proposed that to minimise buy back costs “Transco could force shippers sell back any interruptible at say 18:00hrs which has not been used - a sort of 'use it or lose it' package”.

Transco Response

Transco and Users discussed a reduction in the amount of interruptible capacity to be made available as part of Modification Proposal 0500. Widespread support was expressed for the continued release of relatively high levels of interruptible capacity.

Transco agrees with Dynegy that a form of hourly capacity management could be introduced. However the scope and implications of such a change is large whilst the problem is comparatively small. Transco believes that this Proposal offers a more measured solution that can be introduced at lower cost. Transco considers that LE have offered a variation of the Dynegy solution in that a sub-daily period is created in which capacity rights cannot be carried over from one period to the next. Transco believes that it should continue to develop capacity management rules that offer commercial freedom for Users whilst creating incentives at the margin to facilitate prudent operation.

11.5 Other Issues Raised

Powergen stated that "as it stands this proposal is discriminatory between shippers who happen to manage their capacity and overrun risk in different ways”.

TXU requested that “Transco should report in a detailed manner on the aggregate charges levied, perhaps as a quarterly Agenda item for the NT&T Workstream” and suggested that “it would be appropriate to implement the modification via the transition document, perhaps for an initial six month period which will necessitate a formal debate and review of its effectiveness”.

BGT expressed concern about the timing of the Modification Proposal, and observed that it has “consistently advocated that the Auction process for the allocation of Entry Capacity must be conducted in an environment of stability and certainty. Therefore we oppose any temporal changes to the arrangements for the next round of auctions which take effect after the auction has taken place”.

Transco Response

Transco does not agree that this Proposal is discriminatory. The Proposal is for a change to the Network Code that, if implemented, will be applied on a common basis to all Users. Transco accepts that Users will adopt differing approaches to portfolio management and risk in response to each Users business needs.

Transco does not believe that additional reporting is required in response to this Proposal. The proposed licence will require that all entry overrun charges will be reported as part of the capacity buy back incentive.

Transco believes that this Proposal will further the relevant objectives and therefore should be considered for inclusion in the main body of the Network Code.

Transco sympathises with BGT's concerns about the implementation of changes to the capacity regime during a period for which capacity has been auctioned. It hopes that it will be possible to implement this Proposal before the forthcoming MSEC auctions (which have now been postponed until 16 August).

12. The extent to which the implementation is required to enable Transco to facilitate compliance with safety or other legislation

Implementation is not required for this purpose.

13. The extent to which the implementation is required having regard to any proposed change in the methodology established under Standard Condition 4(5) or the statement furnished by Transco under Standard Condition 4(1) of the Licence

Implementation is not required having regard to any such proposed change.

14. Programme of works required as a consequence of implementing the ModificationProposal

There are no additional works required.

15. Proposed implementation timetable (including timetable for any necessary information systems changes)

Draft Modification Report issued	11th July 2002
Close-out for representation	25th July 2002
Final Modification Report issued	30th July 2002
Ofgem decision expected	1st August 2002
Implementation	1st October 2002
System delivered and first invoice issued	December 2002

16. Recommendation concerning the implementation of the Modification Proposal

Transco recommends implementation.

17. Restrictive Trade Practices Act

If implemented this proposal will constitute an amendment to the Network Code. Accordingly the proposal is subject to the Suspense Clause set out in the attached Annex.

18. Transco's Proposal

This Modification Report contains Transco's proposal to modify the Network Code and Transco now seeks direction from the Gas & Electricity Markets Authority in accordance with this report.

19. Text

SECTION B SYSTEM USE AND CAPACITY

Amend paragraph 1.3.1 to read as follows:

> "….in respect of capacity utilised (or negative capacity), in accordance with this Section B."

Amend paragraph 5.5.2 to read as follows:

> "Subject to paragraph 5.5.4, where a User's…."

Add new paragraphs 5.5.3 and 5.5.4 to read as follows:

"5.5.3 "Subject to paragraph 5.5.4, where a User's Available Firm System Entry Capacity is negative the User will be liable to pay a System Entry Overrun Charge in accordance with paragraph 2.12 on the basis of an overrun quantity on each Day calculated as the sum of :

(i) the magnitude of the User's negative Available Firm System Entry Capacity; and

(ii) the amount (if any) determined to be the overrun quantity in accordance with paragraph 2.12.2 if the User's Available System Capacity Assume Interruptible SEC included for this limb of the calculation. at the Aggregate System Entry Point were zero.

5.5.4 Where in respect of an Aggregate System Entry Point a User's Available System Capacity and Available Firm System Entry Capacity are negative the User will only be liable to pay the greater of the System Entry Overrun Charge determined under paragraphs 5.5.2 and 5.5.3."

Signed for and on behalf of Transco.

Signature:

Tim Davis
Head of Regulation NT&T

Date:

Gas and Electricity Markets Authority Response:

> In accordance with Condition 9 of the Standard Conditions of the Gas Transporters' Licences dated 21st February 1996 I hereby direct Transco that the above proposal (as contained in Modification Report Reference **0554**, version **1.0** dated **30/07/2002**) be made as a modification to the Network Code.

Signed for and on Behalf of the Gas and Electricity Markets Authority.

Signature:

The Network Code is hereby modified with effect from, in accordance with the proposal as set out in this Modification Report, version **1.0**.

Signature:

Process Manager - Network Code

Transco

Date:

Annex

1. Any provision contained in this Agreement or in any arrangement of which this Agreement forms part by virtue of which The Restrictive Trade Practices Act 1976 ("the RTPA"), had it not been repealed, would apply to this Agreement or such arrangement shall not come into effect:

   (i) if a copy of the Agreement is not provided to the Gas and Electricity Markets Authority ("the Authority") within 28 days of the date on which the Agreement is made; or

   (ii) if, within 28 days of the provision of the copy, the Authority gives notice in writing, to the party providing it, that he does not approve the Agreement because it does not satisfy the criterion specified in paragraphs 1(6) or 2(3) of the Schedule to The Restrictive Trade Practices (Gas Conveyance and Storage) Order 1996 ("the Order") as appropriate

   provided that if the Authority does not so approve the Agreement then Clause 3 shall apply.

2. If the Authority does so approve this Agreement in accordance with the terms of the Order <u>(whether such approval is actual or deemed by effluxion of time)</u> any provision contained in this Agreement or in any arrangement of which this Agreement forms part by virtue of which the RTPA, had it not been repealed, would apply this Agreement or such arrangement shall come into full force and effect on the date of such approval.

3. If the Authority does not approve this Agreement in accordance with the terms of the Order the parties agree to use their best endeavours to discuss with Ofgem any provision (or provisions) contained in this Agreement by virtue of which the RTPA, <u>had it not been repealed, would</u> apply to this Agreement or any arrangement of which this Agreement forms part with a view to modifying such provision (or provisions) as may be necessary to ensure that the Authority would not exercise his right to give notice pursuant to paragraph 1(5)(d)(ii) <u>or 2(2)(b)(ii)</u> of the Order in respect of the Agreement as amended. Such modification having been made, the parties shall provide a copy of the Agreement as modified to the Authority pursuant to Clause 1(i) above for approval in accordance with the terms of the Order.

4. For the purposes of this Clause, "Agreement" includes a variation of or an amendment to an agreement to which any provision of paragraphs 1(1) to (4) in the Schedule to the Order applies.